CIAOER IB 75-02 S/NFD 1 of 1

Israel's Case for US Assistance Mar 75 ER IB 75-02

Secret

No Foreign Dissem

Israel's Case for US Assistance

Secret

ER IB 75-2
March 1975

Approved For Release 2000/09/14 : CIA-RDP86T00608R000500160002-9

NATIONAL SECURITY INFORMATION
Unauthorized Disclosure Subject to Criminal Sanctions

Classified by 015319
Exempt from general declassification schedule
of E.O. 11652, exemption category:
§ 5B(1), (2), and (3)
Automatically declassified on:
Date Impossible to Determine

Approved For Release 2000/09/14 : CIA-RDP86T00608R000500160002-9

ISRAEL'S CASE FOR US ASSISTANCE

SUMMARY AND CONCLUSIONS

1. Israel is asking for a substantial hike in military and economic assistance from the United States: Tel Aviv wants US $175 million on top of the more than $1.6 billion of aid in train for 1975 and is seeking $2.6 billion next year. Such aid would bring cumulative receipts from the United States since the October war to $6.4 billion. Before that war, US assistance was only about $400 million annually.

2. The Israeli request assumes a high level of Middle East tension and a need to sustain exceptionally large military imports. The balance-of-payments projection circulated in support of the request forecasts reduced economic activity and an overall drain of foreign exchange reserves even if all the aid sought is given.

3. We do not agree with this Israeli forecast. We believe that the request would provide Israel both "guns and butter"; it would:

- allow Israel to maintain massive military imports at just under $2.5 billion in both 1975 and 1976,
- leave room for a continued, though much reduced, expansion in civilian imports (10%-15% a year in value, although less than 5% in volume), and
- add perhaps $400 million to Tel Aviv's dwindling foreign exchange reserves in the next two years.

Moreover, Israel could minimize reductions in the growth of economic activity by increasing civilian imports instead of accumulating reserves. Announcement of a record budget for the coming year and a backing away from recently imposed austerity measures suggest that the government will follow such a policy.

25X1A

Note: Comments and queries regarding this publication are welcomed. They may be directed to [redacted] of the Office of Economic Research, Code 143, Extension 5741.

4. Israel could meet its military import requirements and still achieve moderate economic growth with as little as $2 billion in US assistance next year. Cuts in imports would be needed if funding were no greater than the $1.6 billion in aid in hand for 1975. Significant savings of non-military imports cannot be accomplished without lowering output, employment, and real incomes. The government appears determined to fight any cutback in proposed military imports even though Israel's direct 1973 war losses have been replaced and its equipment inventories upgraded. Israel placed orders for $1 billion worth of weapons and ammunition in the United States alone in 1974 which, if not funded in future aid programs, will have to be paid for on commercial account. Israel has also been shopping European arms producers, seeking additional large purchases.

DISCUSSION

The Basic "Blue Paper" Numbers

5. The government of Israel projects a bleak economic picture to support its request for a sharp hike in assistance from the United States. It projects a cumulative balance-of-payments deficit of between $650 million and $700 million in both 1975 and 1976, even with a substantial rise in aid receipts. Tel Aviv avers that it cannot pay the full cost both of increased quantities of arms and of civilian imports in the face of the adverse impact of the slumping world economy on foreign exchange earnings. It notes that the bill for defense imports, oil, and basic foodstuffs alone will have jumped from $1 billion in 1972 to $3.7 billion in 1975.

6. As shown in Table 1, Israel is seeking $1.8 billion this year and wants $2.6 billion in 1976, bringing total US assistance to Israel to more than $5.6 billion during 1974-76.[1] An additional $800 million worth of emergency military aid was received in 1973.

The Military Burden

7. Israel lays much of the responsibility for its economic difficulties on a massive jump in military requirements since the 1973 war. Immediately before that war the military was taking one-third of the budget and about 15% of total

1. US aid programs included in these figures are: Exim Bank credits, military sales credits and grants (the $2.2 billion 1973 authorization and a follow-on multi-year program), Foreign Military Sales (FMS) funds, PL-480, AID Housing Guarantees, and Soviet Refugee Assistance. Excluded are US participation in building new petroleum storage facilities, a desalting project, and other minor programs which would entail additional US aid if funded separately. The petroleum project (with the United States paying for the oil to be stored), for example, would cost $13 million in 1975 and rise to nearly $100 million in 1976.

Table 1

Israeli Projection of Foreign Financing Requirements

Million US $

	1974 Estimated	1975 Forecast	1976 Forecast
Imports of goods and services	-7,188	-7,890	-8,600
Defense (direct and indirect)	-1,850	-2,330	-2,450
Civilian	-5,338	-5,560	-6,150
Exports of goods and services	3,540	4,155	4,880
Current account deficit	-3,648	-3,735	-3,720
External debt maturities	-452	-660	-820
Financing requirement	-4,100	-4,395	-4,540
Capital and transfers	1,705	1,980	1,890
Unilateral transfers	930	960	960
Net foreign investment	50	100	120
Israel bond borrowing	310	330	330
Long- and medium-term loans	415	590	480
Import gap before US aid	-2,395	-2,415	-2,650
US aid	1,166	1,806	2,585
In hand	1,166	1,631	....
Newly requested	....	175	2,585
Change in reserves	**-1,229**	**-609**	**-65**

resources available (GNP plus the import surplus); the comparable numbers now are 40% and 30%. In contrast, the defense establishment took only 20% of Israel's resources in 1970 during the war of attrition along the Suez Canal.

8. The sharp escalation of defense spending is shown in Table 2. Budgeted military expenditures have more than doubled in the last two years and are slated to jump more than 25% in FY 1975.

The rise in local military spending reflects:

- an increase from 110,000 to about 150,000 in the number of men under arms,
- higher wage rates and service benefits,
- new fortifications for the Sinai, the West Bank, and the Golan Heights,

Table 2

Israeli Budget Trends[1]

Billion Israeli Pounds

April Through March	1973 Pre-War	1973 Post-War	1974	1975
Total budget	20.0	29.6	40.7	56.3
Defense	6.7	13.8	17.6	22.4
Local spending	3.9	7.7	6.2	8.0
Arms imports	2.8	6.1	11.4	14.4

1. Data are for Israeli fiscal years (April through March). Arms imports of $667 million and $1,450 million in pre- and post-war 1973, $2,300 million in 1974, and $2,400 million in 1975. The value of arms imports in the last five months of FY 1974 and in FY 1975 in terms of Israeli pounds, reflect the November 1974 devaluation from 4.2 pounds to 6.0 pounds to the dollar.

- expanded petroleum storage and other military facilities, and

- increased purchases from domestic industries.

The government is moving toward greater self-sufficiency in arms production and is actively stockpiling supplies; ammunition stores, for instance, have tripled since the war.

9. The major part of the post-1973 military budget is for arms imports. Although war losses were replaced by 1974 under emergency grant aid from the United States, Israel is both augmenting and upgrading equipment stocks. According to Prime Minister Rabin, Israel in 1975 will have increased inventories over those held on the eve of the October war, as follows:

- 85% more artillery,

- 50% more tanks,

- 25% more armored personnel carriers, and

- 20% more combat aircraft.

10. Total Israeli military imports probably were substantially higher in 1974 than officially acknowledged in the "blue paper." The Israelis admit to "direct"

military imports totaling $1,350 million in 1974 with another $500 million worth of "indirect" items (spare parts, raw and intermediate materials, and other inputs for local defense industry). We think defense purchases abroad were $450 million higher, totaling $2,300 million by yearend. The civilian import figures in the aid request show a nearly 40% increase over 1973, which seems inconsistent both with results for the first half of 1974 and with developments in the economy. Moreover, some earlier Israeli announcements indicate a figure closer to our estimate for total military imports (see the Appendix for an analysis of military imports).

The Economy in 1974

11. The impact on the economy of the October 1973 war was quickly dissipated. Israel was able to avoid severe belt-tightening as a result of rising US aid and a drawdown of foreign exchange reserves. Industrial production recovered rapidly from the 20% reduction that occurred during the war and output was 95% of the pre-war level by March 1974. GNP growth was just under 6% in 1974, not very far below rates of 8% to 10% in recent years. The civilian budget rose 75% over pre-war levels partly because of heavy investments in domestic defense industries and in support of new immigrant facilities. Private consumption, which had been expected to drop to 1972 levels, was up nearly 10%.

12. A dark spot in the economy was a reduction in private investment, which was affected by a mid-year suspension of non-essential construction. Overall investment fell an estimated 7% during the year.

13. The annual rate of inflation jumped from 12% pre-war to about 40%. More than one-half of Israel's domestic inflation was the result of higher import prices. However, the impact was not particularly great on the Israeli consumer, who managed to keep pace with price increases by obtaining generous cost-of-living adjustments.

The Balance of Payments

14. The rapid economic recovery stemmed from a boom in imports. The sharp rise in Israel's import bill was not matched, however, by increases in exports of goods and services, which were affected by the recession in Europe and the United States. Accordingly, the current account deficit soared to $3.6 billion, compared with $2.6 billion in 1973 and only $1 billion in 1972. Traditional capital receipts and remittances fell from the peak of 1973, when the response of the

world Jewish community to the war generated exceptionally large gifts and bond purchases. US economic and military aid, which was especially large during 1973 because of speeded up arms deliveries, fell slightly. With import growth outstripping that for foreign exchange receipts, Israel's reserves fell, but the drop was considerably less severe than portrayed in the "blue paper," shown in Table 3.

Table 3

Israel: Balance of Payments

Million US $

	1973 Actual	1974 Estimate "Blue Paper"	1974 Estimate CIA
Imports of goods and services	-5,338	-7,188	-7,188
Military (direct and indirect)	-1,503	-1,850	-2,300
Civilian	-3,835	-5,338	-4,888
Exports of goods and services	2,741	3,540	3,540
Current account deficit	-2,597	-3,648	-3,648
Net remittances and capital	2,027	1,253	1,569
US aid	1,204	1,166	1,166
Sinai oil savings	40	....	300
Change in reserves	674	-1,229	-613

15. We differ with the Israeli balance-of-payments estimate for 1974 in the following respects:

- as much as $450 million worth of military imports may be carried in the civilian accounts, giving Israel a non-military import growth rate of 27% instead of 39%,

- on the basis of announced targets, pledges, and payments information for the first half of the year, gifts and bond sales were $200 million more than indicated by the Israelis,

- commercial borrowings were more than $400 million greater than stated in the Israeli accounts, and

- Israel's import bill is inflated by about $300 million because Israel apparently accounts for imports of Sinai oil at world prices rather than at the actual foreign exchange cost.[2]

16. Although Israel dipped into its foreign exchange holdings to finance the uncovered import bill, the reserve drawdown was about one-half that claimed by Israel. Our estimate is consistent with the $1.2 billion in official reserves reported at the end of December. Yearend holdings were only $300 million below the amount of foreign exchange Israel had on the eve of the October war.

The Economic Outlook for 1975 and 1976

17. The Israelis have forecast a moderate degree of belt-tightening in 1975:

- real GNP growth of 3% will be only one-half last year's rate and one-third that in the immediate pre-war years,

- both public and private consumption will increase slowly, but

- overall investment will again contract, reflecting lower outlays for development and reductions of business inventories.

They also expect that slowdown in world inflation, reduced food subsidies, higher fuel charges and utility taxes, and wage restraints will ease pressures on domestic prices, causing the rate of inflation to slow to just under 20% from the 40% annual rate recorded last year.

The Balance of Payments and Import Capacity

18. We agree with the basic thrust of the "blue paper," which portrays an increasingly large import gap to be covered by US aid or belt-tightening by the Israelis. (For a comparison of the two estimates, see Table 4.) The defense burden and, to a lesser extent, international oil price movements and the depth and duration of the world economic recession will determine the size of the gap.

19. There is little doubt that export proceeds will grow slower than in the recent past (17% projected for each year 1975 and 1976, compared with 19%

2. A fuller accounting of how Israel treats its Sinai oil earnings for balance-of-payments purposes is contained in ER IB 75-1, *Israel: The Importance of Sinai Oil*, February 1975, Secret No Foreign Dissem.

Table 4

Comparison of Israeli and CIA Estimates of Import Gap

Million US $

	1974 Estimate		1975 Forecast		1976 Forecast	
	Israel	CIA	Israel	CIA	Israel	CIA
Foreign exchange earnings[1]	4,793	5,409	5,475	5,975	5,950	6,450
Exports of goods and services	3,540	3,540	4,155	4,155	4,880	4,880
Net remittances and capital	1,253	1,569	1,320	1,520	1,070	1,270
Sinai oil savings	....	300	....	300	....	300
Imports of goods and services	7,188	7,188	7,890	7,890	8,600	8,600
Military	1,850	2,300	2,330	2,330	2,450	2,450
Civilian	5,338	4,888	5,560	5,560	6,150	6,150
Import gap before US aid	2,395	1,779	2,415	1,915	2,650	2,150

1. Import capacity.

in 1973 and 29% in 1974). Exports of luxury goods such as diamonds, fashion clothing, and citrus fruits have slowed in recent months, and tourist receipts are lagging. We think sales of Israeli bonds and remittances from the world Jewish community will be maintained $200 million a year higher than forecast by Israel. The drop in long- and medium-term loan receipts for 1976 projected in the "blue paper" may be overly pessimistic. In any event, Israel cannot look to increased large borrowings in the commercial money markets as a solution to its problems: such borrowings – although increasingly attractive with the easing of interest rates – would be both an insufficient and a temporary approach to the country's basic balance-of-payments difficulties. Finally, we have adjusted our projection to take account of savings realized from access to Sinai oil. A return of the oil fields to Egypt would cost Israel $300 million in 1976.

20. Our estimate of civilian import growth differs substantially from that of the Israelis, mainly because we start from a lower 1974 base. As mentioned above, we think as much as $450 million worth of military imports are carried in the civilian account in 1974. This 1974 aberration is assumed not to be carried into the projections for 1975 and 1976. The discrepancies in import composition do not alter overall imports (and aid needs). By reporting $1,850 million worth of military imports in 1974, Israel strengthens its case for additional armaments and avoids Arab reaction to a higher arms total.

US Aid

21. The levels of aid requested by Israel would nearly eliminate the import gap for 1975 (see the tabulation below). According to our estimate, the additional $175 million in PL-480 Israel wants this year would lower the balance-of-payments deficit to about $100 million. Even if aid remains at the 1975 level, Israel should have little difficulty financing the deficit from its own resources. Provision of the full $2.6 billion package in 1976 would give Tel Aviv a balance-of-payments surplus of more than $400 million next year, while maintaining US aid at the same level as in 1975 would yield a deficit of more than $500 million. A $2 billion program would produce a deficit of about $150 million.

	Million US $				
	1975		1976		
Import gap	1,915			2,150	
US aid	1,631	1,806	1,630	2,000	2,585
Deficit	-284	-109	-520	-150	435

Alternative Import Patterns

22. We believe that Israel will relax its economic policies if prospective US aid is at or near the requested levels for 1975-76. The Rabin government has steadily consolidated its position since coming to office last spring, but it probably does not yet have the political clout to force much economic restraint unless financial problems leave no alternative. Public pressures have caused the government to back away from its most recent austerity move. The real cost of operating automobiles, for example, has not increased significantly for many Israelis because they are given expense allowances by their employers (civil servants, for instance, were granted a 42% increase in the automobile expense allowance), and the ban on auto imports does not apply to new immigrants. Since announcing the November program, the government also has:

- raised business deductions and allowances to offset higher fuel costs and utility charges,

- granted a 30% cost-of-living wage boost in January and has another round of negotiations scheduled for summer, and

- come in with a record-breaking budget accompanied by a deficit of $350 million for the first time in recent years.

23. Israel is probably counting on increased US assistance to help underwrite the increased import bill these economic policies would require.

- Provision of $2.6 billion in aid requested would allow Israel to pursue both its military import program and a fairly rapid economic expansion.

- A $2 billion aid program would permit a large military buildup with moderate belt-tightening.

- The current programed level of US funding – $1.6 billion – would require Israel to restrict imports.

24. A substantial cut in civilian imports would mean a reduction in per capita consumption and little if any overall economic growth. Imports of consumer goods, such as automobiles and household articles, undoubtedly would be severely restricted and their prices would skyrocket. Middle and upper income Israelis, who purchase the bulk of such imports, will be especially hard hit and would make their dissatisfaction quickly known to the government.

25. In order to achieve import savings of the necessary degree, imports of raw and industrial materials would be affected. Lacking most raw materials and weak in heavy industry, there is little Israel can do to substitute domestically produced industrial goods for imports. Cuts in a wide range of imports, therefore, will mean cuts in domestic industrial production. Economic stagnation in turn would mean higher unemployment and lower real incomes for many Israelis. With foreign exchange in short supply, measures designed to minimize unemployment would add to inflation.

26. Israel might be willing to scale down its external military procurement program in 1976, especially if the bulk of the rebuilding program financed by existing US funding is completed. Even if Israel goes ahead with a costly arms buildup along the lines outlined last summer in its Matmon B presentation (estimated at $20 billion in 1974 prices by 1978), we are unable to account for the high level of military supply Israel says it needs this year and next. Purchases of costly new equipment will not comprise a significant share of military imports until the late 1970s, and the inflation factor for US military hardware is running at an annual rate of 10% or less. The 85 F-4s and A-4s Israel has received since the war, for instance, cost only about $350 million.

27. A year or two of economic stagnation caused by a large military burden, although painful for a country accustomed to rapid growth, could still be accommodated. In Israel, the threat of a new war will be accepted as ample reason for economic sacrifices. In the longer term, renewed world economic expansion should enable Israel to earn sufficient foreign exchange to resume economic growth.

APPENDIX

MILITARY IMPORT ESTIMATES

The Israelis report buying $1,850 million worth of military hardware in 1974 in the "blue paper," with nearly three-quarters purchased in the United States. Those purchases equate with estimates put forward early last year in the "grey paper" ($1,825 million) and in the official national budget ($1,800 million).

We believe foreign military purchases probably were closer to $2.3 billion in 1974. At the time of the devaluation in November, Finance Minister Rabinowitz stated that imports of arms would total $2.3 billion for the year. The Israelis contracted for $2 billion worth of US arms in 1974 even though Tel Aviv had only $1 billion in uncommitted aid to cover new military purchases. They were actively seeking arms and related equipment from European suppliers (major items of interest are shown in the accompanying tabulation).

Italy	Helicopters 76-mm automatic guns M-113 APCs and spare parts Artillery ammunition Hydrofoil patrol boats
Britain	Submarines Air cushion vehicles Light trucks Centurian tanks
France	Aircraft, engines, and spare parts Patrol boats
Belgium	Small arms ammunition 175-mm artillery ammunition
West Germany	Torpedos Electronic equipment

Sufficient room exists in Israel's import accounts to cover a higher level of arms purchasing than admitted. We believe military goods are masked in the civilian import account. Israel recorded $2.5 billion worth of civilian imports in the first half of 1974. Civilian imports would have had to increase $400 million -- to $2.9 billion -- in the second half of the year in order to reach the Israeli yearend figure of $5.4 billion. It is difficult to accept the more than 15% rise in civilian imports

between the first and second halves of 1974, given the easing of import prices, the slowdown in civilian construction activity, reduced import subsidies, and the devaluation of the Israeli pound in the last half of the year.